Received
APR 2008
A.H.C.C.C.S.
DHCM

# Care1st Health Plan

## Consolidated Financial Statements and Supplemental Consolidating Information

For the Years Ended December 31, 2007 and 2006

BDO

**BDO Seidman, LLP**
Accountants and Consultants

3200 Bristol Street, 4th Floor
Costa Mesa, California 92626
Telephone: (714) 957-3200
Fax: (714) 957-1080

## Independent Auditors' Report

The Board of Directors
Care1st Health Plan

We have audited the accompanying consolidated balance sheets of Care1st Health Plan (the "Company") as of December 31, 2007 and 2006, and the related consolidated statements of income, stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Care1st Health Plan as of December 31, 2007 and 2006, and the consolidated results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

BDO Seidman, LLP

April 24, 2008

| *December 31,* | 2007 | 2006 |
|---|---|---|
| **Assets** | | |
| **Current assets** | | |
| Cash and cash equivalents | **$ 69,886,510** | $ 68,026,799 |
| Investments | **-** | 20,000,000 |
| Receivables, net | **39,715,927** | 32,659,748 |
| Income tax receivable | **-** | 441,493 |
| Prepaid expenses and other current assets | **1,250,403** | 1,358,269 |
| Deferred tax assets | **1,726,396** | 1,141,000 |
| **Total current assets** | **112,579,236** | 123,627,309 |
| Receivables, net of current portion | **270,608** | 63,333 |
| Investments | **20,000,000** | - |
| Fixed assets, net | **19,533,850** | 16,334,413 |
| Regulatory deposit | **6,800,000** | 6,800,000 |
| Intangible assets, net | **38,096,027** | 45,717,780 |
| Goodwill | **6,493,259** | - |
| Other assets | **-** | 1,994,038 |
| Deferred tax assets, net of current portion | **169,414** | 222,496 |
| **Total assets** | **$ 203,942,394** | $ 194,759,369 |

| *December 31,* | 2007 | 2006 |
|---|---|---|
| **Liabilities and Stockholders' Equity** | | |
| **Current liabilities** | | |
| Capitation and medical claims payable | **$ 67,873,453** | $ 62,788,128 |
| Risk-sharing arrangements | **22,431,955** | 29,543,496 |
| Accounts payable | **4,925,484** | 2,895,784 |
| Accrued expenses | **6,171,721** | 3,199,633 |
| Income tax payable | **128,020** | - |
| Current maturities of long-term debt | **800,000** | 800,000 |
| Other current liabilities | **1,966,146** | 7,124,146 |
| Total current liabilities | **104,296,779** | 106,351,187 |
| Long-term debt, less current maturities | **12,399,994** | 13,199,998 |
| Deferred tax liability | **3,081,502** | 1,540,664 |
| **Total liabilities** | **119,778,275** | 121,091,849 |
| **Commitments and contingencies** | | |
| **Stockholders' equity** | | |
| Preferred stock: | | |
| Series A, cumulative, nonvoting; no par value; 1,000,000 shares authorized, 45,509 shares issued and outstanding, liquidation preference of $8,601,800 and $8,146,710 at December 31, 2007 and 2006, respectively | **45,509** | 45,509 |
| Series B, cumulative, nonvoting; no par value; 1,000,000 shares authorized, 9,956 shares issued and outstanding, liquidation preference of $1,991,200 and $1,891,640 at December 31, 2007 and 2006, respectively | **9,956** | 9,956 |
| Common stock: | | |
| Series A, no par value; 1,000,000 shares authorized, 3,000 shares issued and outstanding | **3,000** | 3,000 |
| Series B, no par value; 1,000,000 shares authorized, 3,000 shares issued and outstanding | **3,000** | 3,000 |
| Additional paid-in capital | **33,940,299** | 33,940,299 |
| Retained earnings | **50,162,355** | 39,665,756 |
| Total stockholders' equity | **84,164,119** | 73,667,520 |
| Total liabilities and stockholders' equity | **$ 203,942,394** | $ 194,759,369 |

*The accompanying notes are an integral part of these consolidated financial statements.*

# Care1st Health Plan

## Consolidated Statements of Income

| *For the years ended December 31,* | 2007 | 2006 |
|---|---|---|
| **Revenues** | | |
| Premium revenue | $ 497,480,819 | $ 365,280,345 |
| Interest income | 4,325,776 | 3,597,019 |
| Other revenue | 3,145,022 | 405,244 |
| Total revenues | 504,951,617 | 369,282,608 |
| **Expenses** | | |
| Healthcare services | 432,681,943 | 315,405,985 |
| Selling, general and administrative expenses | 52,415,344 | 40,898,693 |
| Depreciation and amortization | 3,624,064 | 1,367,740 |
| Total expenses | 488,721,351 | 357,672,418 |
| **Income from operations** | 16,230,266 | 11,610,190 |
| **Interest expense** | (1,176,465) | (776,761) |
| **Other income** | 1,877,757 | 1,081,283 |
| **Income before provision for income taxes** | 16,931,558 | 11,914,712 |
| **Provision for income taxes** | (6,434,959) | (4,808,003) |
| **Net income** | $ 10,496,599 | $ 7,106,709 |

*The accompanying notes are an integral part of these consolidated financial statements.*

## Consolidated Statements of Cash Flows

| *For the years ended December 31,* | **2007** | 2006 |
|---|---|---|
| **Cash flows from operating activities** | | |
| Net income | **$ 10,496,599** | $ 7,106,709 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities | | |
| Depreciation and amortization | **3,624,064** | 1,367,740 |
| Allowance for reinsurance receivables | **1,951,087** | 1,126,140 |
| Deferred income taxes | **1,008,524** | 405,083 |
| Loss on sale of fixed assets | **-** | 7,807 |
| Changes in assets and liabilities, net of acquisition of UHP: | | |
| Receivables | **(9,214,541)** | (8,702,871) |
| Income taxes | **569,513** | 275,015 |
| Prepaid expenses and other current assets | **107,866** | (547,191) |
| Capitation and medical claims payable | **4,131,408** | 26,831,954 |
| Risk-sharing arrangements | **(7,111,541)** | 5,994,515 |
| Accounts payable | **2,029,700** | 1,104,376 |
| Accrued expenses | **2,972,088** | 986,315 |
| Other current liabilities | **(5,158,000)** | 5,921,378 |
| Net cash provided by operating activities | **5,406,767** | 41,876,970 |
| **Cash flows from investing activities** | | |
| Purchase of investments | **-** | (20,000,000) |
| Purchases of fixed assets | **(4,741,090)** | (1,150,680) |
| Proceeds from sale of fixed assets | **-** | 32,000 |
| Acquisition of UHP | **1,994,038** | (31,994,038) |
| Net cash used in investing activities | **(2,747,052)** | (53,112,718) |
| **Cash flows from financing activities** | | |
| Proceeds – note payable | **-** | 3,000,000 |
| Repayments – note payable | **(800,004)** | (700,002) |
| Capital contribution | **-** | 16,000,098 |
| Net cash (used in) provided by financing activities | **(800,004)** | 18,300,096 |

## Consolidated Statements of Cash Flows (Continued)

| *For the years ended December 31,* | **2007** | 2006 |
|---|---|---|
| **Net increase in cash and cash equivalents** | **1,859,711** | 7,064,348 |
| **Cash and cash equivalents** | | |
| Beginning of year | **68,026,799** | 60,962,451 |
| End of year | **$ 69,886,510** | $ 68,026,799 |
| **Supplemental information** | | |
| Income taxes paid | **$ 5,660,000** | $ 4,125,000 |
| Interest paid | **837,419** | 774,886 |

*The accompanying notes are an integral part of these consolidated financial statements.*

## 1. Organization and Significant Accounting Policies

*Organization*

Care1st Health Plan (the "Company") was incorporated under the laws of the State of California in March of 1994 as part of a joint venture agreement between Cal-Care Medical Group, Los Angeles Medical Center, Crown City Medical Group, Pacific Alliance Medical Center and Queen of Angels/Hollywood Presbyterian Medical Center. During 1999, Pacific Alliance Medical Center purchased the shares of common stock previously owned by Queen of Angels/Hollywood Presbyterian Medical Center. Accordingly, Pacific Alliance Medical Center currently owns 50% of the Company.

The Company is a Health Maintenance Organization ("HMO") formed for the purpose of providing a full range of medical and hospital services to Medi-Cal beneficiaries residing in Los Angeles County. Under the terms of the contract with the Local Initiative Health Authority for Los Angeles County ("L.A. CARE"), eligible Medi-Cal beneficiaries residing within the service area may voluntarily apply for enrollment or be assigned by L.A. CARE to the Company, with enrollment in this program not to exceed 250,000 members, which was increased due to the acquisition of the Maxicare Plan Partner Contract (see Note 2).

The Company has been licensed by the California Department of Corporations (the "DOC") since November 1995. Effective in 2000, HMOs in the State of California are regulated by the Department of Managed Health Care (the "DMHC"). The DMHC is exclusively devoted to the licensing and regulation of healthcare service plans or HMOs. The DMHC will continue to enforce the Knox-Keene Act relating to the regulation of HMOs and has increased authority to protect health plan subscribers and enrollees.

The Company also maintains a contract with the California Managed Risk Medical Insurance Board to provide care to members who voluntarily enroll in the Healthy Families Program.

**1. Organization and Significant Accounting Policies (Continued)**

Effective October 1, 2003, the Company commenced operations of Care1st Health Plan Arizona, Inc. (the "Arizona Plan"), a wholly-owned subsidiary of the Company. The Arizona Plan is a prepaid health plan based in Phoenix, Arizona, that derives substantially all of its revenues through a contract with the Arizona Health Care Cost Containment System ("AHCCCS") to provide specified health services to qualified members. The contract provides for fixed monthly premiums, currently based on negotiated per capita enrollee rates. The Arizona Plan subcontracts with hospitals, physicians and other medical providers within Arizona to care for AHCCCS members in Maricopa County. The Arizona Plan participates in the Acute Care, Developmental Disabilities ("DDD-DES"), and Health Care Group ("HCG") Programs. The initial three-year contract began on October 1, 2003, and was to expire on September 30, 2006. In August 2006, the Arizona Plan renewed its contract with AHCCCS through to October 2008. Subsequent renewals remain at the discretion of AHCCCS. (See Note 9)

During 2004, the Company submitted an application to participate in the Sacramento County Medi-Cal GMC (Geographic Managed Care) Program. In late 2004, the Company was given approval and effective April 14, 2005, the Company commenced operations in that county. The term of the agreement was May 1, 2005 through December 31, 2006. The Company renewed this contract through to December 31, 2009. Effective November 1, 2007, the Company sold this line of business to an unrelated health plan for approximately $1,000,000. The operations and assets disposed of were not significant, and accordingly, separate discontinued operation disclosure in accordance with Statement of Financial Accounting Standards No. 144 was not required due to immateriality. The entire amount of the sale price was recorded as other income and is included in the consolidated statement of income for the year ended December 31, 2007.

Through November 1, 2007, in accordance with the Sacramento County Medi-Cal GMC Program, the Company contracted directly with the California Department of Health Services ("DHS") to

**1. Organization and Significant Accounting Policies (Continued)**

provide healthcare services to members enrolled in the DHS Medi-Cal Managed Care Program in Sacramento County. In accordance with the contract, DHS remitted monthly capitation or premium payments to the Company for eligible enrollees.

Effective February 2006, the Company was given approval to commence operations in the San Diego County Medi-Cal GMC program. The San Diego County Medi-Cal GMC contract was set to expire on December 31, 2007. In March 2008, this contract was amended and renewed through to December 31, 2008.

In February 2005, the Company submitted an application to Centers for Medicare and Medicaid Services ("CMS"), seeking appointment to the Medicare Advantage Program in Arizona. On October 18, 2005, CMS advised the Company that it had been awarded a Medicare Advantage Contract ("MA") through December 2006, after which the Company commenced MA operations in Arizona by Care1st Health Plan Arizona, Inc., dba ONECare. The MA contract is renewed successively for one year period at a time. ONECare receives monthly capitation premiums per enrollee from CMS. In accordance with the MA Program, ONECare provides enrollees (generally in Maricopa County, Arizona) eligible for Medicare coverage with healthcare services including the Part D Prescription Drug Benefit.

In May 2005, the Company incorporated the wholly-owned subsidiary ONECare by Care1st Health Plan of Arizona, Inc., which was dormant through December 31, 2005. In 2006, the Company transferred its Arizona MA operations into this wholly-owned subsidiary.

In September 2006, the purchase of certain assets by the Company from WATTSHealth Foundation, Inc. dba UHP Healthcare ("UHP") pursuant to an April 2006 executed agreement, became effective. These assets included contracts and business related to Medi-Cal, Medicare, Commercial and Dental plans (See Note 2).

**1. Organization and Significant Accounting Policies (Continued)**

*Basis of Presentation*

The Company prepares its financial statements in accordance with guidelines established by the AICPA Auditing and Accounting Guide for "Health Care Organizations." The following significant accounting policies used in the preparation of the accompanying consolidated financial statements are in accordance with accounting principles generally accepted in the United States of America and have been consistently applied.

*Principles of Consolidation*

The consolidated financial statements include the accounts of the Company and its subsidiary. All significant intercompany transactions and accounts have been eliminated in consolidation.

*Management Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses for each reporting period. The significant estimates made in the preparation of the Company's consolidated financial statements relate to the assessments of the carrying values of receivables, goodwill, intangible assets, capitation and claims payable, and risk-sharing arrangements. Actual results could materially differ from the estimates upon which the carrying values were based.

*Cash and Cash Equivalents*

The Company considers all highly liquid investments that are readily convertible to cash, with original maturity dates of three months or less when purchased, to be cash and cash equivalents.

**1. Organization and Significant Accounting Policies (Continued)**

The Company maintains cash deposits in financial institutions that exceed the amounts insured by the U.S. government. Nonperformance by these institutions could expose the Company to losses for amounts in excess of the insured balances. At December 31, 2007 and 2006, the Company's cash and cash equivalents exceeded federally–insured limits by approximately $85,709,000 and $85,803,000, respectively. The Company has not experienced, nor does it anticipate, nonperformance by the institutions.

***Investments***

Investments are comprised primarily of fixed income debt and equity securities with short-term maturities and are classified as available-for-sale, because the Company does not have the intent to hold these securities to maturity. Available-for-sale securities are carried at fair value, with unrealized gains or losses reported in other comprehensive income, net of tax. The Company has no investments that are considered to be trading securities. The carrying values of the investments of $20,000,000 approximates the fair values at December 31, 2007 and 2006. There were no unrealized gains or losses relating to the investments for the years ended December 31, 2007 and 2006, and as such there were no amounts that comprised other comprehensive income.

At December 31, 2007, the $20,000,000 of available-for-sale securities were invested in primarily municipal-insured auction rate securities instruments. Recently, due to the turmoil in the credit markets, the auctions at which these securities are traded failed resulting in concerns as to the liquidity of these investments. Accordingly, these investments have been classified as non-current as of December 31, 2007.

***Fixed Assets***

Fixed assets are stated at cost, net of depreciation, and depreciated on the straight-line method over the estimated useful lives of the assets. Leasehold improvements are stated net of amortization and are amortized over a period not exceeding the term of the lease.

**1. Organization and Significant Accounting Policies (Continued)**

Computer software costs that are incurred in the preliminary project stage are expensed as incurred. External direct costs expended on each project are capitalized and amortized over a five-year period when placed in operation. Estimated useful lives of fixed assets are as follows:

| | Estimated Lives |
|---|---|
| Buildings and improvements | 10 – 39 years |
| Furniture and fixtures | 5 – 10 years |
| Computer software | 3 years |
| Computer and office equipment | 3-5 years |
| Leasehold improvements | 5 years |
| Vehicles | 3 years |

***Intangible Assets, Net***

In July 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 142, *Goodwill and Intangible Assets* ("SFAS 142"), which revised the accounting for purchased goodwill and intangible assets. Under SFAS 142, goodwill and intangible assets with indefinite lives are no longer to be amortized and will be evaluated for impairment annually and written down when the recorded value exceeds the estimated fair value. The Company adopted the provisions of SFAS 142 effective January 1, 2002. The Company evaluates its goodwill and intangible assets annually. The Company completed its evaluation of the impact of SFAS 142 on its goodwill and intangible assets for the years ended December 31, 2007 and 2006, and determined that there had been no impairment as of December 31, 2007 and 2006.

**1. Organization and Significant Accounting Policies (Continued)**

*Impairment of Long-Lived Assets*

The Company periodically evaluates whether events or circumstances have occurred that may affect the estimated useful life or the recoverability of the remaining balance of identifiable intangible assets. Impairment of an intangible asset is triggered when the estimated future undiscounted cash flows (excluding interest charges) do not exceed the carrying amount of the intangible asset. If events or circumstances indicate that the remaining balance of the intangible asset may be permanently impaired, such potential impairment will be measured based upon the difference between the carrying amount of the intangible asset and the fair value of such asset determined using the estimated future discounted cash flows (excluding interest charges) generated from the use and ultimate disposition of the respective intangible asset.

***Recognition of Premium Revenue and Related Healthcare Services***

Healthcare premiums from the Company's enrolled members are reported as revenue in the month in which enrollees are entitled to receive healthcare services.

The Company arranges comprehensive healthcare services for its members principally through capitation, a fixed monthly payment made without regard to the frequency, extent or nature of the healthcare services actually furnished. Benefits are provided to enrolled members generally through the Company's contractual relationships with physician groups and hospitals. The Company's contracted providers may, in turn, contract with specialists or referral providers for specific services and the Company is responsible for any related payments to those referral providers. The liability for medical claims payable includes claims in process and a provision for incurred but not yet reported claims computed on an experience basis. Claims processing expenses are also accrued based on an estimate of expenses necessary to process such claims.

**1. Organization and Significant Accounting Policies (Continued)**

The Company has a program that provides incentives to participating contracted primary care providers and hospitals through the use of risk-sharing agreements. Payments are made to contracted primary care providers and hospitals based on the risk-sharing agreements. Expenses related to the program are recorded as incurred based on contracted amounts.

***AHCCCS Specific Revenue Recognition***

Delivery supplemental payments are intended by AHCCCS to cover the costs of maternity care for deliveries during a prospective enrollment period. Such premiums are recognized in the month the delivery occurs.

HIV/AIDS supplemental payments are intended by AHCCCS to cover the costs of HIV/AIDS drugs for enrolled members. Such premiums are recognized as revenue in the month the member receives the drugs.

Hospital supplement payments are intended by AHCCCS to defray the costs of Title XIX Waiver Group medical members hospitalized on the date of application and when the date of application falls within the members' eligibility period. The revenue is recognized in the month the plan is notified of the members' eligibility.

Reinsurance revenues are recorded at estimated amounts due to the Arizona Plan pursuant to the AHCCCS contract net of estimated uncollectible amounts. Acute reinsurance revenue is recognized as a percentage of expenses incurred by members whose medical costs exceed a stated deductible per member per contract year. Catastrophic reinsurance revenue is recognized as the actual costs paid by the Arizona Plan. These revenues are included as an offset of other medical expenses.

Prior Period Coverage ("PPC") capitation premiums are payments received from AHCCCS for the period of time, prior to the member's enrollment, during which a member is eligible for covered services. Such premiums are recognized upon receipt.

**1. Organization and Significant Accounting Policies (Continued)**

*Claims Payable and Related Expenses*

Medical claims payable and related expenses are accrued as services are rendered and include estimates for claims that have been incurred but not reported. Since the liability is based upon estimates, the ultimate settlement of claims may be more or less than the amount included in the consolidated financial statements. The methods for making such estimates, and for establishing the resulting expenses, are continually reviewed and updated, and the difference between the estimated liability and the subsequent revisions, including those related to the actual settlement of claims, is recognized in the period the claims are revised. While the ultimate amount of program expenses is dependent on future developments, management is of the opinion that the liability for claims payable is adequate to cover such expenses.

*Income Taxes*

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards No. 109 ("SFAS 109"), *Accounting for Income Taxes*. Under the asset and liability method as required by SFAS 109, deferred income taxes are recognized for the tax consequences of temporary differences by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. Under SFAS 109, the effect on deferred income taxes of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is recognized if it is more likely than not that some portion, or all of, a deferred tax asset will not be realized. No valuation allowances were recorded at December 31, 2007 and 2006.

**1. Organization and Significant Accounting Policies (Continued)**

***Concentration of Credit Risk***

The premium revenues related to the Medi-Cal Agreements represent approximately 48% and 52% of the Company's total consolidated premium revenue for the years ended December 31, 2007 and 2006, respectively.

The premium revenues related to the AHCCCS Agreement represent approximately 27% and 32% of the Company's total consolidated premium revenue for the years ended December 31, 2007 and 2006, respectively (See Note 9).

The premium revenues related to the Medicare Agreements represent approximately 23% and 13% of the Company's total consolidated premium revenue for the years ended December 31, 2007 and 2006, respectively.

The premium revenues related to other agreements represent approximately 3% and 2% of the Company's total consolidated premium revenue for the years ended December 31, 2007 and 2006, respectively.

***New Accounting Pronouncements***

In July 2006, the FASB issued FASB Interpretation No. 48 ("FIN 48") *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109.* FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS 109. It prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Additionally, FIN 48 provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. In November 2007, the FASB voted to defer the effective date of FIN 48 for all nonpublic entities. As a result, FIN 48 will first go into effect for nonpublic companies for period beginning after

**1. Organization and Significant Accounting Policies (Continued)**

December 15, 2007. The adoption of FIN 48 is not expected to have a material impact on the Company's consolidated results of operations or consolidated financial position.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ("SFAS 157"). SFAS 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements. The changes to current practice resulting from the application of this statement relate to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company will adopt SFAS 157 in fiscal year 2008 and does not expect these provisions to have a material impact on its consolidated financial position or consolidated results of operations.

In February 2008, the FASB issued a staff position ("FSP 157-1") indicating that SFAS 157 does not apply under SFAS No. 13 *Accounting for Leases,* and other accounting pronouncements that address fair value measurements for purposes of lease classifications under SFAS No. 13. Also in February 2008, the FASB issued a staff position ("FSP 157-2") indicating a deferral of the effective date of SFAS 157 for one year for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, ("SFAS 159") to permit all entities to choose to elect, at specified election dates, to measure eligible financial instruments at fair value. An entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date, and recognize upfront costs and fees related to those items in earnings as incurred and not deferred. SFAS 159 applies to fiscal years beginning after November 15, 2007, with early adoption

**1. Organization and Significant Accounting Policies (Continued)**

permitted for an entity that has also elected to apply the provisions of SFAS 157, *Fair Value Measurements*. An entity is prohibited from retrospectively applying SFAS 159, unless it chooses early adoption. SFAS 159 also applies to eligible items existing at November 2007 (or early adoption date). The Company will adopt SFAS 159 in fiscal year 2008 and does not expect these provisions to have a material impact on its consolidated financial position or consolidated results of operations.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51* ("SFAS 160"). SFAS 160 amends ARB No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. Further, it requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. SFAS 160 also establishes a single method of accounting for changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation, requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated, requires expanded disclosures in the consolidated financial statements that clearly identify and distinguish between the interests of the parent's owners and the interests of the noncontrolling owners of a subsidiary, among others. SFAS 160 is effective for fiscal years beginning on or after December 15, 2008, with early adoption permitted, and it is to be applied prospectively. The Company does not expect the adoption of SFAS 160 to have a material impact on its consolidated financial position or consolidated results of operations.

In December 2007, the FASB issued SFAS No. 141(Revised 2007), *Business Combinations* ("SFAS 141(R)"). SFAS 141(R) replaces SFAS 141, but retains the fundamental requirements in SFAS 141 that the acquisition method of accounting be used for all business

**1. Organization and Significant Accounting Policies (Continued)**

combinations and for an acquirer to be identified for each business combination. SFAS 141(R) requires the recognition and measurement in an entity's financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree entity. Further, SFAS 141(R) requires the recognition and measurement of goodwill acquired in a business combination or a gain from a bargain purchase. Lastly, SFAS 141(R) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of a business combination. SFAS 141(R) is to be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Early adoption is not permitted.

***Reclassifications***

Certain amounts in the prior years' consolidated financial statements have been reclassified to conform to the 2007 presentation.

**2. Intangible Assets, Net**

***Licensing Costs***

Intangible assets in the amount of approximately $637,000 relate to fees incurred by the Company to obtain the necessary regulatory licenses. Licensing costs are being amortized on a straight-line basis over a period of 20 years, the amortization period initiated when the Company received its DOC license in November 1995. At December 31, 2007 and 2006, the gross carrying value of this intangible asset subject to amortization was $1,608,772. At December 31, 2007 and 2006, accumulated amortization was $971,431 and $890,992, respectively. Amortization expense for the years ended December 31, 2007 and 2006 was approximately $80,000 for each year. The estimated amortization expense scheduled for each of the five succeeding years and thereafter are approximately $80,000 per year for the years 2008, 2009, 2010, 2011, 2012, and approximately $235,000 for 2013 and thereafter.

**2. Intangible Assets, Net (Continued)**

*Maxicare Intangible*

Effective December 1, 2001, the Company acquired certain assets of Maxicare ("Maxicare"), a California Corporation, for $15,000,000. The acquired assets consisted primarily of the Plan Partner Contract with L.A. CARE, which provides the Company with additional enrollment of Medi-Cal subscribers from L.A. CARE, with the Company's enrollment from L.A. CARE not to exceed a maximum of 250,000 members. The terms of the Plan Partner Contract are the same as the existing contract that the Company maintains with L.A. CARE. Initially, the Medi-Cal subscriber intangible assets were deemed to have an indefinite life, however, at December 31, 2007, in accordance with SFAS 142, the Company's management reevaluated the useful lives of the Medi-Cal subscribers and determined them to have a finite useful life of approximately 13 years. Accordingly, the Company will prospectively begin amortizing the $15,000,000 of acquired intangible assets in fiscal year 2008. The estimated amortization expense scheduled for each of the five succeeding years and thereafter are approximately $1,154,000 for fiscal years 2008 through 2012, and approximately $9,231,000 for fiscal year 2013 and thereafter. In accordance with SFAS 142, the Company will evaluate the remaining useful life of the finite-lived intangible asset at the end of each fiscal year to determine whether events and circumstances warrant a revision to the remaining period of amortization. If the estimate of the finite-lived intangible asset's remaining useful life is changed, the remaining carrying amount of the intangible asset will be amortized prospectively over that revised remaining useful life.

*UHP Acquisition*

On April 10, 2006, the Company entered into an agreement to purchase certain assets of UHP Healthcare ("UHP") for $30,000,000. UHP Healthcare is a nonprofit Knox-Keene HMO licensed in California, currently operating under Chapter 11 of the Bankruptcy Code.

**2. Intangible Assets, Net (Continued)**

The acquired assets related primarily to UHP Healthcare's Medicare Advantage program ("MA"), its Medi-Cal program with L.A. Care, its Denti-Cal program, and certain commercial insurance programs. Additionally, acquired assets included membership agreements, a provider network, licenses and permits, and records related to the above agreements. In addition, the purchase price of the assets included a five year non-compete agreement by UHP. Implicit in the purchase price, Company also assumed certain liabilities primarily incurred but not reported claims up to approximately $7,900,000 as defined by the agreement. Accordingly, the net cash paid was approximately $22,100,000. The agreement was subject to regulatory approval and accordingly became effective September 1, 2006.

As of December 31, 2006, the Company determined that the total amount of claims paid relating to such assumed liabilities was approximately $9,900,000, approximately $2,000,000 in excess of the $7,900,000 in initially-estimated liabilities. As the actual payment amount of $9,900,000 exceeded estimated liabilities of $7,900,000, the resulting difference established a receivable balance of approximately $2,000,000 as of December 31, 2006, shown as other assets on the consolidated balance sheet.

Of the total cash paid by the Company, approximately $10,200,000 was set aside in accordance with two separate escrow agreements, subject to the resolution of the final estimated value of the assumed liabilities within 24 months from the date of closing. Pursuant to the Book Value Escrow Agreement entered into on August 31, 2006, the Company was to be refunded 100% for all claims in excess of the estimated $7,900,000 up to approximately $13,200,000 in claims. This refund was subject to agreement and audit by UHP.

The Book Value Escrow Agreement was executed as result of a difference in opinion between UHP and the Company's actuaries as to the ultimate value of the liabilities assumed. Accordingly, approximately $5,200,000 was placed into an escrow account for this purpose. In addition, in accordance with original purchase

**2. Intangible Assets, Net (Continued)**

agreement, if claims relating to the assumed liabilities exceed the estimated value, the Company and UHP were to share the excess on a 50:50 basis up to $5,000,000. Therefore, an additional $5,000,000 was placed into an escrow cash reserve account for this purpose. This was subject to the Post Closing Escrow Agreement also executed on August 31, 2006.

During 2007, the Company continued to pay out further claims in excess of the $9,900,000 previously paid in 2006. Accordingly, the Company engaged independent actuaries to produce a revised estimate of total claims. In August 2007, the revised actuarial estimate reflected a total anticipated liability $16,800,000. This final estimate was agreed upon by the Company and the trustees of UHP. Based on this resolution in accordance with the various escrow arrangements, the Company received $7,600,000 in cash; of the total expected incurred claims, approximately $960,000 were subject to appeals to be resolved by UHP and offset against the liability, and accordingly, the final adjusted purchase price for the acquisition was determined to be approximately $30,400,000. In summary, the final purchase price was determined as follows:

| | | |
|---|---|---|
| Total cash paid at closing | $ | 22,060,274 |
| Total claims paid and assumed | | 16,815,426 |
| | | 38,875,700 |
| Total cash received from escrow | | (7,563,932) |
| Total claims subject to appeal | | (958,509) |
| Total purchase price, as adjusted | $ | 30,353,259 |

**2. Intangible Assets, Net (Continued)**

As a result of the resolution of these matters, the purchase price for the acquisition of certain assets of UHP was subsequently revised during the year ended December 31, 2007, as follows:

| | As of September 1, 2006 | Adjustments | As of August 14, 2007 |
|---|---|---|---|
| Cash paid | $ 22,060,274 | $ - | $ 22,060,274 |
| Estimated liabilities assumed | 7,939,726 | 353,259 | 8,292,985 |
| Total purchase price | $ 30,000,000 | $ 353,259 | $ 30,353,259 |

Contemporaneous with the revision and the resolution of the purchase price of the UHP assets, the purchase price allocation of assets acquired between intangible assets and goodwill were finalized in accordance with SFAS 142. As a result of this allocation, the Company's management determined that the finite-lived intangible assets acquired have various useful lives ranging from 5 to 15 years, and accordingly, were subject to amortization, based on a straight-line basis. However, it was also determined that the amortization period relating to these finite-lived intangible assets were to have begun since the initial asset acquisition date of September 1, 2006. Therefore, amortization of the identified finite-lived intangible assets were calculated retrospectively from September 1, 2006 through to December 31, 2007, which amounted to approximately $498,000 for the period from September 1, 2006 through December 31, 2006, and approximately $1,504,000 for the year ended December 31, 2007, for total amortization of approximately $2,002,000. This amount was charged to the consolidated statements of income for the year ended December 31, 2007. The estimated amortization expense scheduled for each of the five succeeding years and thereafter are approximately $1,503,000, $1,623,000, $1,864,000, $1,859,000, $1,849,000, and $13,160,000 for fiscal years 2008, 2009, 2010, 2011, 2012, and 2013 and thereafter, respectively.

**2. Intangible Assets, Net (Continued)**

The following table summarizes the estimated fair values of assets acquired and liabilities assumed as of the acquisition date and adjustments made thereto:

| | Purchase Price Allocation | | |
|---|---|---|---|
| | As of September 1, 2006 | Adjustments | As of August 14, 2007 |
| **Assets acquired** | | | |
| Intangible assets and goodwill subject purchase price allocation | $ 30,000,000 | $ (30,000,000) | $ - |
| Intangible assets subject to amortization: | | | |
| Medi-Cal subscribers – 13 year life | - | 8,860,000 | 8,860,000 |
| Medicare subscribers – 12 year life | - | 6,040,000 | 6,040,000 |
| Provider network – 15 year life | - | 9,970,000 | 9,970,000 |
| Non-compete agreement – 5 year life | - | 70,000 | 70,000 |
| Goodwill | - | 6,493,259 | 6,493,259 |
| Total assets acquired | 30,000,000 | 1,433,259 | 31,433,259 |
| **Liabilities assumed** | | | |
| Commercial loss contracts assumed | - | 1,080,000 | 1,080,000 |
| Total liabilities assumed | - | 1,080,000 | 1,080,000 |
| Net assets acquired | $ 30,000,000 | $ 353,259 | $ 30,353,259 |

In accordance with SFAS 142, the Company will evaluate the remaining useful life of the finite-lived intangible asset at the end of each fiscal year to determine whether events and circumstances warrant a revision to the remaining period of amortization. If the estimate of the finite-lived intangible asset's remaining useful life is changed, the remaining carrying amount of the intangible asset will be amortized prospectively over that revised remaining useful life.

**2. Intangible Assets, Net (Continued)**

Goodwill recognized in the transaction amounted to approximately $6,500,000, and that amount is expected to be fully deductible for tax purposes.

The following table provides a summary of intangible assets and the accumulated amortization as of December 31, 2007 and 2006:

| | 2007 | 2006 |
|---|---|---|
| Licensing costs | $ 1,608,772 | $ 1,608,772 |
| UHP intangible assets (refer previous table) | - | 30,000,000 |
| Medi-Cal subscribers: | | |
| UHP acquisition | 8,860,000 | - |
| Maxicare | 15,000,000 | 15,000,000 |
| Medicare subscribers | 6,040,000 | - |
| Provider network | 9,970,000 | - |
| Non-compete agreement | 70,000 | - |
| Total acquisition cost of intangible assets subject to amortization | 41,548,772 | 46,608,772 |
| Accumulated amortization | (3,452,745) | (890,992) |
| Intangible assets, net | $ 38,096,027 | $ 45,717,780 |

**3. Receivables**

Receivables consist of the following at December 31, 2007 and 2006:

| | 2007 | 2006 |
|---|---|---|
| Due from L.A. CARE | $ 19,524,238 | $ 18,513,078 |
| Due from AHCCCS, net of allowances of $3,077,227 and $1,126,140, respectively | 18,768,832 | 13,167,305 |
| Due from CMS, net | 72,574 | 143,432 |
| Other | 1,620,891 | 899,266 |
| Total receivables | 39,986,535 | 32,723,081 |
| Non-current | (270,608) | (63,333) |
| Total receivables, current portion | $ 39,715,927 | $ 32,659,748 |

**3. Receivables (Continued)**

At December 31, 2007 and 2006, the Company reflected amounts owing by L.A. CARE of $19,524,238 and $18,513,078, respectively. These amounts due to the Company generally related to Medi-Cal enrollee capitation receivables under the Local Initiative. These receivables were subsequently paid in January 2008 and 2007, respectively.

At December 31, 2007 and 2006, $4,085,725 and $6,228,238 of the AHCCCS receivables related to reinsurance receivables due to the Arizona Plan.

Additionally, due to uncertainty regarding actual utilization, AHCCCS intends to limit its financial risk to its contractors. Accordingly, profits and losses for Title XIX Waiver Group members and PPC members with the exception of certain risk groups are annually reconciled as defined for each contract year ending in the month of September. In accordance with the reconciliation, profits and losses for the various risk group members are generally limited to 2% of capitation for that group. Profits or losses in excess of the 2% corridor are reimbursed to, or recovered from, AHCCCS by the contractor. For contract year ending in September 2008 for the Title XIX Waiver Group members, profits and losses are limited to 3% of capitation. Accordingly, at December 31, 2007 and 2006, the Arizona Plan recorded net receivables from AHCCCS in the amounts of $10,208,732 and $5,033,423, respectively. These receivables are included in the table above as "Due from AHCCCS." Generally, the final reconciliation and settlement is anticipated to take place no more than 15 months after the contract year-end. Accordingly, at December 31, 2007 and 2006, the Arizona Plan has reflected estimated settlement receivables for contract years ending September 30, 2008 and September 30, 2007, in the amounts of $270,608 and $63,333, respectively, as non-current. This amount is expected to be settled in December 2008.

**3. Receivables (Continued)**

An estimated amount of $3,065,581 and $1,115,909 for the HCG program was also recorded as settlement receivables by the Arizona Plan at December 31, 2007 and 2006, respectively. This estimated settlement receivable was computed in accordance with AHCCCS regulations intending to limit financial risk to the contractor.

The remaining receivables at December 31, 2007 and 2006, due from AHCCCS in the amount of $1,408,794 and $789,735, respectively, recorded by the Arizona Plan related primarily to capitation due and other items.

**4. Fixed Assets**

Fixed assets consist of the following at December 31, 2007 and 2006:

| | 2007 | 2006 |
|---|---|---|
| Land | $ 3,550,000 | $ 3,550,000 |
| Buildings and improvement | 13,994,742 | 11,577,112 |
| Furniture and fixtures | 1,840,231 | 515,179 |
| Purchased software | 2,655,760 | 2,628,502 |
| Computer equipment | 3,951,095 | 3,035,201 |
| Leasehold improvements | 444,977 | 817,278 |
| Motor vehicles | 24,000 | - |
| | 26,460,805 | 22,123,272 |
| Less accumulated depreciation | (6,926,955) | (5,788,859) |
| Total | $ 19,533,850 | $ 16,334,413 |

Depreciation expense amounted to $1,541,653 and $1,287,301 for the years ended December 31, 2007 and 2006, respectively.

As of December 31, 2007 and 2006, software costs of $2,655,760 and $2,628,502, respectively, have been capitalized. Amortization expense related to these software costs and included in the depreciation amount above for the years ended December 31, 2007 and 2006 was approximately $161,756 and $123,928, respectively.

## 5. Long-Term Debt

Long-term debt is comprised of the following:

| *December 31,* | **2007** | 2006 |
|---|---|---|
| Note payable to bank, original principal amount $12,000,000, entered into June 2005, bearing interest at a fixed rate of 5.86% per annum, with monthly repayments of principal of $50,000 plus interest accruing on the outstanding balance. Payments on the note are to be made through June 2015, where all remaining principal is due in full. The note is secured by buildings. | **$ 10,500,000** | $ 11,100,000 |
| Note payable to bank, original principal $3,000,000, dated May 2006, bearing interest at a fixed rate of 6.93% per annum, with monthly repayments of principal of $16,667 plus interest accruing on the outstanding balance. Payments on the note are to be made through May 2013, where all remaining principal is due in full. The note is secured by cash pledged as collateral by Care1st Health Plan – California in the amount of approximately $3,000,000 recorded as cash and cash equivalents. | **2,699,994** | 2,899,998 |
| Less current maturities | **(800,000)** | (800,000) |
| | **$ 12,399,994** | $ 13,199,998 |

**5. Long-Term Debt (Continued)**

The notes payable to the bank have various financial and non-financial covenants. The most significant financial covenant is for the Company to maintain a debt service coverage ratio of at least 1.25 to 1 annually through the term of the notes. Additionally, the $3,000,000 note requires the Company to maintain a tangible effective net worth of not less than $25,000,000, an annual minimum net income of not less than $3,000,000, and the Company continue to have not less than $12,000,000 in liquid assets as defined. At December 31, 2007, and as of the date of these consolidated financial statements, the Company was in compliance with all the covenants pursuant to the note agreements.

Maturities of long-term debt are as follows:

| *Years ending December 31,* | |
|---|---|
| 2008 | $ 800,000 |
| 2009 | 800,000 |
| 2010 | 800,000 |
| 2011 | 800,000 |
| 2012 | 800,000 |
| 2013 and thereafter | 9,199,994 |
| | $ 13,199,994 |

**6. Related-Party Transactions**

The Company has entered into various agreements with stockholders to provide medical care services to a significant number of the Company's members. The amounts due to stockholders include accrued capitation, and amounts related to their risk-sharing agreements with the Company in which funds remaining in the hospital and medical expense pools are paid according to the agreements. For the years ended December 31, 2007 and 2006, the Company had paid under its capitation and risk-sharing arrangements approximately $44,968,000 and $35,300,000, respectively, to the stockholders. The Board of Directors is comprised of individuals from each of the stockholders in proportion to their ownership interests.

**7. Income Taxes**

The provision for income taxes consists of the following for the years ended December 31, 2007 and 2006:

| | | 2007 | | 2006 |
|---|---|---|---|---|
| **Current** | | | | |
| Federal | $ | **4,327,265** | $ | 3,572,067 |
| State | | **1,099,170** | | 830,853 |
| | | **5,426,435** | | 4,402,920 |
| **Deferred** | | | | |
| Federal | | **851,827** | | 312,149 |
| State | | **156,697** | | 92,934 |
| | | **1,008,524** | | 405,083 |
| Total | $ | **6,434,959** | $ | 4,808,003 |

The 2007 and 2006 overall effective tax rate differs from the statutory federal tax rate primarily due to permanent differences as well as state income taxes, net of federal benefit.

The Company's deferred taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes at December 31, 2007 and 2006. Significant components of the Company's deferred tax assets and liabilities are as follows:

| *December 31,* | | 2007 | | 2006 |
|---|---|---|---|---|
| **Deferred tax liability** | | | | |
| Depreciation and amortization | $ | **3,073,857** | $ | 1,540,664 |
| Other | | **7,645** | | - |
| **Total deferred tax liability** | | **3,081,502** | | 1,540,664 |
| **Deferred tax assets** | | | | |
| Depreciation and amortization | | **169,414** | | 222,496 |
| Vacation accrual | | **337,471** | | 260,737 |
| Other accruals and allowances | | **584,852** | | 146,100 |
| Other, primarily state taxes | | **804,073** | | 734,163 |
| **Total deferred tax assets** | | **1,895,810** | | 1,363,496 |
| **Total deferred tax liabilities, net** | $ | **(1,185,692)** | $ | (177,168) |

**7. Income Taxes (Continued)**

Deferred tax assets and liabilities are classified as follows for the years ended December 31, 2007 and 2006:

| | | | | |
|---|---|---|---|---|
| Deferred tax assets, current | $ | **1,726,396** | $ | 1,141,000 |
| Deferred tax asset, noncurrent | | **169,414** | | 222,496 |
| Deferred tax liability, noncurrent | | **(3,081,502)** | | (1,540,664) |
| **Total deferred tax liabilities,** net | $ | **(1,185,692)** | $ | (177,168) |

The Arizona Plan pays a premium tax of 2% on total capitation and premiums, including reinsurance and other reimbursement paid by AHCCCS. For the years ended December 31, 2007 and 2006, the premium taxes were approximately $2,454,000 and $2,392,000, respectively, and are included in selling, general and administrative expenses.

**8. Equity**

At December 31, 2007 and 2006, preferred stock was issued and outstanding, for which the following is applicable:

In the event of liquidation, dissolution, or winding-up of the Company, holders of Series A and B Preferred Stock (Series A Preferred Stock in preference to Series B Preferred Stock) are entitled to receive an amount equal to $100.00 per share of Series A and B Preferred Stock plus any accrued and unpaid dividends.

Commencing October 1, 1995 and on the first day of October of each year thereafter, holders of Series A and Series B Preferred Stock are entitled to cumulative dividends at the per share rate of $10.00 per annum. Dividends will accrue on each share whether or not declared by the Board of Directors.

As of December 31, 2006, dividends in arrears were $3,595,810 and $896,040 for Series A and Series B Preferred Stock, respectively.

**8. Equity (Continued)**

As of December 31, 2007, dividends in arrears were $4,050,900 and $995,600 for Series A and Series B Preferred Stock, respectively.

During 2007 and 2006, the Company's Board of Directors did not declare or pay any dividends.

In August 2006, pursuant to the purchase of certain assets from UHP, the shareholders of the Company contributed additional capital in the amount of approximately $16,000,000 in cash. No additional shares were issued to the existing shareholders. The decision not to issue additional shares pursuant to this capital contribution was unanimously approved by the existing shareholders. Accordingly, the capital contribution was recorded as additional paid-in-capital.

**9. Commitments and Contingencies**

*Operating Leases*

The Company is obligated under noncancelable operating leases for its premises and equipment expiring at various dates through 2010. Future minimum lease payments under noncancelable operating leases as of December 31, 2007 are as follows:

| *Years ending December 31,* | Operating Leases |
|---|---|
| 2008 | $ 823,606 |
| 2009 | 596,565 |
| 2010 | 55,375 |
| 2011 | 7,712 |
| | $ 1,483,258 |

Rent expense of approximately $1,381,000 and $1,470,000 was charged to operations for the years ended December 31, 2007 and 2006, respectively.

**9. Commitments and Contingencies (Continued)**

*L.A. CARE Agreement*

During 1996, the State of California Department of Health Services (the "SDHS") contracted with L.A. CARE to be the locally created healthcare service plan for Los Angeles County. L.A. CARE commenced operations effective May 1, 1997, at which time the Company's contract with the SDHS terminated, and Medi-Cal enrollment was assigned by L.A. CARE to the Company, up to a maximum of 250,000 members. The Company has a current contract with L.A. CARE through March 1, 2009.

*AHCCCS Agreement*

In early 2008, AHCCCS issued a procurement bid for a new five-year contract to be effective October 1, 2008. There can be no assurance that the Arizona Plan's efforts to renew its contract with AHCCCS will be successful.

*Performance Bond*

Pursuant to its contract with the State of Arizona, the Arizona Plan is required to provide either a performance bond or designated substitute to guarantee performance of the Plan's obligations under the contract. As of December 31, 2007, the Arizona Plan has two performance bonds in the amounts of $8,000,000 and $2,000,000, for a total of $10,000,000. These performance bonds expire concurrently with the end of the AHCCCS contract in 2008. In accordance with AHCCCS regulations, the performance bond amount has been excluded from the balance sheet as of December 31, 2007 and 2006. The performance bonds are backed by a $10,000,000 line of credit (see Note 10).

*UHP Acquisition*

Pursuant to the asset purchase agreement, within 30 days of the emergence of UHP from bankruptcy, the Company agreed to make charitable contributions to UHP of $100,000, as well as $100,000 for each of the four years thereafter, totaling $500,000. To date, UHP has not emerged from bankruptcy, and no amounts have been accrued for as of December 31, 2007.

**9. Commitments and Contingencies (Continued)**

***General Matters and Litigation***

The Company is subject to claims and legal proceedings which include the usual obligations incurred by a health plan. The Company purchases commercial Managed Care Errors and Omissions Insurance on a claims-made basis with a $50,000 deductible for each claim. The limits of liability are $5,000,000 for each claim and $10,000,000 in the aggregate. Although management is unable to ascertain the ultimate outcome of such matters, after review and consultation with counsel and taking into consideration relevant insurance coverage and related deductibles, management believes that the outcome of these matters will not have a materially adverse effect on the financial position of the Company.

**10. Regulatory Requirements**

The Company must meet certain minimum requirements under the Knox-Keene Health Care Service Plan Act of 1975, as amended (the "Act"), to ensure that the Company can provide the medical benefits for which it has contracted. The Company is required by the Act to maintain a minimum deposit. Pursuant to these requirements, as of December 31, 2007 and 2006, $300,000 was invested in certificates of deposit, and is recorded as a restricted asset in the accompanying balance sheets. In addition, the Company is required to maintain a minimum tangible net equity as defined by Section 1300.76 of the Act. As of December 31, 2007 and 2006, the Company was in compliance with the Act.

AHCCCS has established certain financial viability criteria and performance goals. At December 31, 2007 and 2006, the Arizona Plan met the minimum equity per member criteria requirement. In addition, the Company is required to maintain a restricted deposit. The restricted deposit is invested in a money market account, stated at fair value in accordance with AHCCCS regulations. The restricted deposit amounted to $4,000,000 at December 31, 2007 and 2006, respectively. In addition to the restricted deposit, the Company also maintained a $2,500,000 certificate of deposit stated

**10. Regulatory Requirements (Continued)**

at fair value as security for the $10,000,000 letter of credit facility (see Note 9). The letter of credit facility was extended in November 2006 through to November 2009. Regulatory deposits amounted to $6,800,000 at December 31, 2007 and 2006.

**11. Retirement Plan**

The Company sponsors a 401(k) defined contribution retirement plan (the "Plan"), available to all employees meeting eligibility requirements. Employees' contributions are voluntary, with an annual maximum contribution of 20% of gross compensation, not to exceed the IRS limit. The employer's matching contribution is based on the Safe Harbor requirements under the 401(k) defined contribution retirement plan. The employee has a choice of investing in various investment funds, subject to Internal Revenue Service limits. Company contributions to the Plan totaled approximately $497,000 and $316,000 for the years ended December 31, 2007 and 2006, respectively.

# Care1st Health Plan

## Supplemental Consolidating Balance Sheets

| *December 31, 2007* | Care1st Health Plan California | Care1st Health Plan Arizona* | Eliminations | Care1st Health Plan Consolidated |
|---|---|---|---|---|
| **Assets** | | | | |
| **Current assets** | | | | |
| Cash and cash equivalents | $ 55,532,171 | $ 14,354,339 | $ - | $ 69,886,510 |
| Receivables, net | 21,138,330 | 18,577,597 | - | 39,715,927 |
| Prepaid expenses and other current assets | 902,441 | 347,962 | - | 1,250,403 |
| Due from affiliates | 759,521 | - | (759,521) | - |
| Deferred tax assets, current portion | 1,447,476 | 278,920 | - | 1,726,396 |
| Total current assets | 79,779,939 | 33,558,818 | (759,521) | 112,579,236 |
| Receivables, non-current | - | 270,608 | - | 270,608 |
| Investments | 20,000,000 | - | - | 20,000,000 |
| Fixed assets, net | 18,943,236 | 590,614 | - | 19,533,850 |
| Regulatory deposit | 300,000 | 6,500,000 | - | 6,800,000 |
| Investment in affiliate | 7,615,594 | - | (7,615,594) | - |
| Intangible assets, net | 38,096,027 | - | - | 38,096,027 |
| Goodwill | 6,493,259 | - | - | 6,493,259 |
| Deferred tax assets, net of current portion | - | 169,414 | - | 169,414 |
| Total assets | $ 171,228,055 | $ 41,089,454 | $ (8,375,115) | $ 203,942,394 |
| **Liabilities and Stockholders' Equity** | | | | |
| **Current liabilities** | | | | |
| Capitation and medical claims payable | $ 41,015,729 | $ 26,857,724 | $ - | $ 67,873,453 |
| Risk-sharing arrangements | 22,431,955 | - | - | 22,431,955 |
| Accounts payable | 4,032,864 | 892,620 | - | 4,925,484 |
| Accrued expenses | 5,486,168 | 685,553 | - | 6,171,721 |
| Income tax payable | 128,020 | - | - | 128,020 |
| Current maturities of long-term debt | 800,000 | - | - | 800,000 |
| Due to affiliates | - | 759,521 | (759,521) | - |
| Other current liabilities | 1,966,146 | - | | 1,966,146 |
| Total current liabilities | 75,860,882 | 29,195,418 | (759,521) | 104,296,779 |
| Long-term debt, less current maturities | 12,399,994 | - | - | 12,399,994 |
| Deferred tax liability, net | 3,081,502 | - | - | 3,081,502 |
| Total liabilities | 91,342,378 | 29,195,418 | (759,521) | 119,778,275 |
| **Stockholders' equity** | | | | |
| Preferred stock | 55,465 | - | - | 55,465 |
| Common stock | 6,000 | 1,000 | (1,000) | 6,000 |
| Additional paid-in capital | 33,940,299 | 7,614,594 | (7,614,594) | 33,940,299 |
| Retained earnings | 45,883,913 | 4,278,442 | - | 50,162,355 |
| Total stockholders' equity | 79,885,677 | 11,894,036 | (7,615,594) | 84,164,119 |
| Total liabilities and stockholders' equity | $ 171,228,055 | $ 41,089,454 | $ (8,375,115) | $ 203,942,394 |

* Consolidated including ONECare, wholly-owned subsidiary of Care1st Health Plan Arizona

*See independent auditors' report on page S-1 and accompanying notes to consolidated financial statements.*

## Supplemental Consolidating Statements of Income

| *For the year ended December 31, 2007* | Care1st Health Plan California | Care1st Health Plan Arizona* | Eliminations | Care1st Health Plan Consolidated |
|---|---|---|---|---|
| **Revenues** | | | | |
| Premium revenue | $ 346,384,777 | $ 152,915,053 | $ (1,819,011) | $ 497,480,819 |
| Interest income | 3,074,576 | 1,251,200 | - | 4,325,776 |
| Other revenue | 3,145,022 | - | - | 3,145,022 |
| Total revenues | 352,604,375 | 154,166,253 | (1,819,011) | 504,951,617 |
| **Operating expenses** | | | | |
| Healthcare services | 298,798,075 | 133,883,868 | - | 432,681,943 |
| Selling, general and administrative expenses | 37,152,803 | 17,081,552 | (1,819,011) | 52,415,344 |
| Depreciation and amortization | 3,209,777 | 414,287 | - | 3,624,064 |
| Total expenses | 339,160,655 | 151,379,707 | (1,819,011) | 488,721,351 |
| **Income from operations** | 13,443,720 | 2,786,546 | - | 16,230,266 |
| **Interest expense** | (1,176,465) | - | - | (1,176,465) |
| **Other income** | 1,877,757 | - | - | 1,877,757 |
| **Income before provision for income taxes** | 14,145,012 | 2,786,546 | - | 16,931,558 |
| **Provision for income taxes** | (5,568,662) | (866,297) | - | (6,434,959) |
| **Net income** | $ 8,576,350 | $ 1,920,249 | $ - | $ 10,496,599 |

* Consolidated including ONECare, wholly-owned subsidiary of Care1st Health Plan Arizona

*See independent auditors' report on page S-1 and accompanying notes to consolidated financial statements.*

## Supplemental Detailed Balance Sheet for Care1st Health Plan Arizona

| *December 31, 2007* | Acute Care | DES-DDD | HCG | Eliminations (a) | Subtotal | ONECare (MA) | Eliminations (a) | Care1st Health Plan Arizona |
|---|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | | |
| **Current Assets** | | | | | | | | |
| Cash and cash equivalents | $ 12,490,336 | $ - | $ 927,836 | $ - | $ 13,418,172 | $ 936,167 | $ - | $ 14,354,339 |
| Receivables | 15,368,052 | 71,391 | 3,065,580 | - | 18,505,023 | 72,574 | - | 18,577,597 |
| Prepaid expenses and other current assets | 253,114 | 50,371 | 14,716 | - | 318,201 | 29,761 | | 347,962 |
| Investment in affiliates | 726,675 | - | - | - | 726,675 | - | (726,675) | - |
| Deferred tax asset | 278,920 | - | - | - | 278,920 | - | - | 278,920 |
| Total current assets | 29,117,097 | 121,762 | 4,008,132 | - | 33,246,991 | 1,038,502 | (726,675) | 33,558,818 |
| Receivables, non-current | 270,608 | - | - | - | 270,608 | - | - | 270,608 |
| Fixed Assets, net | 584,975 | - | - | - | 584,975 | 5,639 | - | 590,614 |
| Regulatory deposit | 6,500,000 | - | - | - | 6,500,000 | - | - | 6,500,000 |
| Deferred tax asset, net | 169,414 | - | - | - | 169,414 | - | - | 169,414 |
| Total assets | $ 36,642,094 | $ 121,762 | $ 4,008,132 | $ - | $ 40,771,988 | $ 1,044,141 | $ (726,675) | $ 41,089,454 |

(a) Due to/from amounts between Acute, DES-DDD, HCG and MA programs netted within Care1st Health Plan Arizona

*See independent auditors' report on page S-1 and accompanying notes to consolidated financial statements.*

## Supplemental Detailed Balance Sheet for Care1st Health Plan Arizona

| December 31, 2007 | Acute Care | DES-DDD | HCG | Eliminations (a) | Subtotal | ONECare (MA) | Eliminations (a) | Care1st Health Plan Arizona |
|---|---|---|---|---|---|---|---|---|
| **Current liabilities** | | | | | | | | |
| Medical claims payable: | | | | | | | | |
| Hospitalization | $ 8,569,570 | $ (350,597) | $ 228,703 | $ - | $ 8,447,676 | $ 2,335,949 | $ - | $ 10,783,625 |
| Physician | 3,748,096 | 291,025 | (534,427) | - | 3,504,694 | 1,123,828 | - | 4,628,522 |
| Other medical expenses | 3,538,538 | 278,179 | 2,432,572 | - | 6,249,289 | 720,178 | - | 6,969,467 |
| PPC expenses | 4,476,110 | - | - | - | 4,476,110 | - | - | 4,476,110 |
| Total medical claims payable | 20,332,314 | 218,607 | 2,126,848 | - | 22,677,769 | 4,179,955 | - | 26,857,724 |
| Accounts payable and accrued expenses | 1,320,728 | 1,079 | 15,609 | - | 1,337,416 | 240,757 | - | 1,578,173 |
| Due to (from) affiliates | 4,336,064 | (1,033,937) | 1,976,184 | - | 5,278,311 | (4,268,790) | (250,000) | 759,521 |
| Total current liabilities | 25,989,106 | (814,251) | 4,118,641 | - | 29,293,496 | 151,922 | (250,000) | 29,195,418 |
| **Stockholders' equity** | | | | | | | | |
| Common stock | 1,000 | - | - | - | 1,000 | - | - | 1,000 |
| Additional paid in capital | 7,114,597 | - | - | - | 7,114,597 | 976,672 | (476,675) | 7,614,594 |
| Retained earnings (deficit) | 3,537,391 | 936,013 | (110,509) | - | 4,362,895 | (84,453) | - | 4,278,442 |
| Total shareholders' equity (deficit) | 10,652,988 | 936,013 | (110,509) | - | 11,478,492 | 892,219 | (476,675) | 11,894,036 |
| Total liabilities and shareholders' equity | $ 36,642,094 | $ 121,762 | $ 4,008,132 | $ - | $ 40,771,988 | $ 1,044,141 | $ (726,675) | $ 41,089,454 |

(a) Due to/from amounts between Acute, DES-DDD, HCG and MA programs netted within Care1st Health Plan Arizona

*See independent auditors' report on page S-1 and accompanying notes to consolidated financial statements.*

## Supplemental Detailed Statement of Income for Care1st Health Plan Arizona

| *For the year ended December 31, 2007* | Acute Care | DES-DDD | HCG | Subtotal | ONECare (MA) | Care1st Health Plan Arizona |
|---|---|---|---|---|---|---|
| **Revenues:** | | | | | | |
| Capitation | $ 92,704,696 | $ 2,097,878 | $ 6,481,991 | $ 101,284,565 | $ 20,327,173 | $ 121,611,738 |
| PPC capitation | 10,075,838 | - | - | 10,075,838 | - | 10,075,838 |
| Hospital supplement | 4,983,404 | - | - | 4,983,404 | - | 4,983,404 |
| Delivery supplement | 8,629,341 | - | - | 8,629,341 | - | 8,629,341 |
| HIV-AIDS supplement | 320,060 | - | - | 320,060 | - | 320,060 |
| TWG settlement | (1,760,611) | - | - | (1,760,611) | - | (1,760,611) |
| PPC settlement | 7,105,612 | - | - | 7,105,612 | - | 7,105,612 |
| Other income | - | - | 1,949,671 | 1,949,671 | - | 1,949,671 |
| Total premium revenues | 122,058,340 | 2,097,878 | 8,431,662 | 132,587,880 | 20,327,173 | 152,915,053 |
| Interest income | 1,251,200 | - | - | 1,251,200 | - | 1,251,200 |
| Total revenues | 123,309,540 | 2,097,878 | 8,431,662 | 133,839,080 | 20,327,173 | 154,166,253 |
| **Operating Expenses:** | | | | | | |
| Healthcare expenses | | | | | | |
| Hospitalization | 46,274,343 | (458,507) | 2,467,144 | 48,282,980 | 6,566,953 | 54,849,933 |
| Physician | 30,720,908 | 260,008 | 1,460,521 | 32,441,437 | 3,043,156 | 35,484,593 |
| Other medical expenses | 38,963,698 | 548,927 | 4,293,338 | 43,805,963 | 7,240,313 | 51,046,276 |
| Reinsurance and third party liability recoveries | (7,558,379) | 61,445 | - | (7,496,934) | - | (7,496,934) |
| Net healthcare expenses | 108,400,570 | 411,873 | 8,221,003 | 117,033,446 | 16,850,422 | 133,883,868 |
| Selling, general and administrative expenses | 11,169,349 | 182,450 | 623,199 | 11,974,998 | 2,652,810 | 14,627,808 |
| Depreciation and amortization | 409,453 | - | - | 409,453 | 4,834 | 414,287 |
| Premium tax expense | 2,453,744 | - | - | 2,453,744 | - | 2,453,744 |
| Total selling, general and administrative expenses | 14,032,546 | 182,450 | 623,199 | 14,838,195 | 2,657,644 | 17,495,839 |
| Total expenses | 122,433,116 | 594,323 | 8,844,202 | 131,871,641 | 19,508,066 | 151,379,707 |
| Income before provision for income taxes | 876,424 | 1,503,555 | (412,540) | 1,967,439 | 819,107 | 2,786,546 |
| Provision (Benefit) for income taxes | (272,467) | (467,434) | 128,253 | (611,648) | (254,649) | (866,297) |
| Net income (loss) | $ 603,957 | $ 1,036,121 | $ (284,287) | $ 1,355,791 | $ 564,458 | $ 1,920,249 |

*See independent auditors' report on page S-1 and accompanying notes to consolidated financial statements.*